only available means (other than exogenous treatment) of obtaining partial rate recovery of the incremental SFAS-106 costs.

The Commission had specifically assured carriers that prefunding would not be determinative of the rate recovery decision:

> Carriers that elected to wait until the GAAP change becomes effective before expending funds for OPEBs are not necessarily foreclosed from recovering these costs.[49]

Based on the Commission's 1992 and 1993 orders and notices regarding exogenous treatment of SFAS-106, and absent a favorable ruling in the current investigation, the only means thus far of obtaining rate recovery of the increased costs recognized under accrual accounting for OPEBs has been for SWBT to have prefunded VEBA contributions during the 1988-90 time period. Clearly, however, SWBT cannot undo its prior funding decisions. Had the Commission clearly stated during the 1988-90 time period that it would foreclose rate recovery of OPEB costs absent prefunding, SWBT would have prefunded VEBAs. Of course, prior orders indicate the Commission did not do so. It is unreasonable into not prefunding VEBAs, if it does not now allow exogenous treatment.

i. <u>The Vast Majority of TBO Costs Are Associated With Periods Under ROR Regulation.</u>

SWBT does not and cannot control the effect of SFAS-106 on its recognition of accounting costs for OPEB related to the TBO. The TBO is SWBT's obligation to current and future retirees for of those increased costs.[51] Thus, the ability to increase selected rates as a result of increased costs cannot be characterized as an opportunity for a windfall. The net incomes of the price cap LECs will definitely be <u>reduced</u> by SFAS-106.

The Commission should understand a fundamental point here. SWBT has not attempted to utilize the existing exogenous treatment provision in the Commission's price cap rules to "game" the process.[52] SWBT has been consistent in its willingness to utilize estimates that can be demonstrated to be conservative[53] in nature, underestimating the warranted exogenous amount. SWBT's actuarial valuation uses a projection of long-term medical care cost that is very conservative. SWBT's use of the approach used by Godwins is also very conservative.

Further, SWBT has committed to make any subsequent reductions to its price cap indexes of appropriate amounts to eventuality is very remote[54] -- that might be caused by exogenous SFAS-106. SWBT's entire approach remains very conservative. SWBT volunteers to make any needed price cap reductions in the future, should the need arise. SWBT has also acknowledged its willingness to remove the TBO exogenous amount from the operation of the inflation-less-productivity adjustment in the price cap formula.[55]

The aggressive nature of the cost containment embodied in SWBT's valuation also obviates the need for concern regarding the elimination of benefits. Small cuts in the level of benefits associated with the types of reforms the Commission contemplated[56] are dwarfed by the overall 0% medical inflation assumption. It is because of the use of the 0% medical inflation assumption in SWBT's defined dollar benefit cap that subsequent changes in benefit levels should not be a concern.

The Commission has explicitly addressed its expectations regarding the possibility that carriers would cut benefits:

> We would like to make it clear that our decision here does not in any way restrict LECs from providing adequate health care packages to their employees. Nor does our decision require these companies to cut back their benefits to their employees.[57]

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[54] As a result, price cap index reduction should occur if SWBT's OPEB claims were expected to be below the levels included in SWBT's actuarial valuation as reduced for the effects of the defined-dollar benefit cap.

[55] SWBT D&J, at p. 3-11.

[56] One example is generic prescription drug programs. See January Order, para. 54. Moreover, as discussed in SWBT's D&J, Tariff Transmittal No. 2271, at pp. 3-15 and 3-18, SWBT already has a generic prescription drug program.

[57] January Order, at para. 41.

The January Order, referring to cost management programs, states that "these types of cost control measures [can be introduced] without changing the underlying benefits that are provided."[58] The Commission's conclusion on this point is wrong; cost control measures like the means suggested in Paragraph 54 of the January Order represent reductions in benefits. Clearly, efficiency gains are desirable; as previously discussed, SWBT has already availed itself of many of the very efficiency measures suggested by the Commission. It is simply incorrect, however, to allege that these cost control measures do not change the benefits provided. SFAS-106 valuation methods (including the valuation performed for SWBT by its enrolled actuary) correctly incorporate the effects of co-payments, benefit caps, shared expense requirements, restricted access to medical facilities, procedures and personnel and other utilization authorizations, as reductions to the overall level of health care benefits.

SFAS-106 requires that major changes in plan provisions and/or actuarial assumptions be taken into account when computing subsequent years' net periodic OPEB expense. Changes of a magnitude sufficient to cause the TBO to fall below the estimate contained in SWBT's valuation would be highly unlikely, at best. However, such changes and changes of much smaller magnitudes are required by SFAS-106 to be quantified and amortized over the remaining service lives of plan participants.

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[58] Id., at para. 54.

In the event of any material benefit level reductions, the existing SFAS-106 accounting and GAAP requirements would force SWBT to disclose the dollar value of such changes in benefit plans and SWBT would be willing to make negative exogenous adjustments for the amounts of any such reductions. Moreover, SWBT would be willing to submit to the Commission (on an annual basis) a positive reporting of the level of OPEB benefits that would allow the Commission to track whether or not SWBT had significantly reduced its OPEB costs. Such a report would allow the Commission to observe annually the cumulative financial effect of changes in actuarial assumptions, changes in plan provisions and changes in the size of the retiree population to which OPEBs are provided. A draft proposal for such a report is included here as Appendix C.

VEBA Trusts in accord with existing accounting rules. In the LECs' 1990 and 1992 Annual Access Tariff Filings, the Commission addressed these expenses, and generally, the OPEB expenses were allowed.[59] SWBT understands that, not counting the recent Annual Filing rates allowed to take effect subject to investigation, at least five of eleven price cap LECs, and a large number of LECs under rate of return regulation, are currently recovering some amount of accrual accounting for OPEBs in their interstate rates approved by the Commission.

The Commission has further summarized its position on the accrual of expenses prior to SFAS-106 implementation:

> The OPEB expenses some LECs have embedded in their July 1990 rates were introduced pursuant to existing accounting rules that permitted LECs, at their option, to change their accounting treatment of OPEB expenses. Carriers that chose to accrue OPEB expenses were not more right or wrong than carriers that chose to await the GAAP change. Under the rate of return regulatory structure, as long as the carrier's costs are reasonable and prudent, these costs can be used in the ratemaking process to justify rates.[60]

Given the Commission's stated position on the accrual of OPEB expenses, the Commission should now allow full interstate rate recovery for LECs who chose to await the GAAP change. SWBT is requesting that the Commission allow SWBT an opportunity to be

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[59] Annual 1990 Access Tariff Filings, 5 FCC Rcd 4177 (1990) at paras. 305-310. (Disallowances associated with out-of-period 1989 OPEB expenses were made in two study areas.) See also, fn. 56, supra. for references to the Annual 1992 Access Tariff Filings.

[60] LEC Price Cap Order on Reconsideration, at para. 61.

treated as least as well as other regulated carriers that are currently receiving rate recovery for accrual accounting for OPEBs.

2. **<u>The TBO is Not Double Counted in the Commission's ROR Represcription.</u>**

The <u>January Order</u> states that no party has introduced evidence on what the investors' expectations were regarding rate recovery of SFAS-106 costs, implying that the Commission's rate of return represcription provided some amount of recovery for the increased OPEB costs that will be incurred by the price cap LECs under SFAS-106 accounting.[61] The <u>MO&O</u> continues to express uncertainty as to whether there is any double counting in the prior ROR represcription despite significant evidence that no such double count could exist.

As SWBT has already shown in its Reply Comments in the 1993 Annual Access Tariff filing proceedings, the allegations automatically imply a change in the cost of capital. In fact, most changes in stock prices are market driven and are independent of the type of business risk that is characterized as possibly representing investors' expectations regarding rate recovery of SFAS-106 costs. However, the business risk of not recovering these costs necessarily would be reflected in reduced earnings expectations and, concomitantly, a lower stock price. And that type of effect -- reduced earnings expectations and reduced stock prices -- does not affect the cost of capital as determined by the Commission's ROR represcription.

The Commission's Part 65 Rules that govern its calculation of cost of equity used in the ROR represcription process uses both stock prices and earnings data.[62] These rules were in place and were utilized by the Commission for the 1990 ROR represcription. The two estimates of cost of equity, K_{e1} and K_{e2}, contained in the Commission's procedures utilize the same methods to estimate stock price and the level of dividends, and use two different methods to estimate future earnings.

The K_{e1} estimate of cost of equity uses a growth estimate, G_1, which is an historical estimate of the annual growth in quarterly dividends over the past two-year period. The K_{e2} estimate of cost of equity uses a growth estimate, G_2, which is an average of the IBES median analysts' five-year annual growth rate estimates of earnings. The basic formula for cost equity used by the Commission is:

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[62] 47 C.F.R. Section 65.303 (cost of common stock equity).

$$K_e = D / P + G$$

where D is the level if dividend payment, P is the stock price and G is the expected annual growth in dividends.

Expectations regarding earnings are definitely reflected in both the stock price, P, and growth expectations, G. A new revelation regarding lack of rate recovery would theoretically reduce two of the inputs to this formula equally -- both the stock price, P, and expected growth, G -- while D, the historical level of the dividend would be unaffected.

Thus, changes in earnings expectation, which have equal effects on both P and G, leave the Commission measure of cost of equity unchanged.

No evidence has been presented which indicates that either of the two measures of cost equity contains any reflection of lack of recovery of SFAS-106 costs in the Commission's ROR represcription results. Also, no evidence exists to suggest that the two alternative methods yielded a different estimate of an effect which has not yet been proven to exist.

Changes in the cost of capital are caused by changes in risk, not simply by a change in stock price. In fact, the Commission has stated that:

> [a]n increase in the price of a stock, however, may leave the stock's expected return unchanged if the price rose to adjust for higher anticipated profits rather than lower investor perceived risk.[63]

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[63] Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, 5 FCC Rcd 7507 (1990) at para. 133.

The underlying weakness in all of the arguments that the cost of capital already contains a premium to account for SFAS-106 costs is quite straightforward. Any perceived stock price effects are caused by possible changes in dividend and earnings growth assumptions. The stock price effects do not materialize on their own, the two -- stock prices and earnings/dividends -- go hand-in-hand. Even Drazen, MCI's witness, acknowledged this linkage when he stated that "efficient markets theory argues that a future anticipated change in cost and hence earnings will be reflected in current stock prices."[64]

Thus, for an expectation regarding rate recovery of accrual accounting for OPEBs to have an effect on cost of capital, it must be shown that a change in stock prices occurred that was not also reflected in a change in earnings expectations. The link between earnings and stock price has long been recognized. For example, The Stock Market: Theories and Evidence (James H. Lorie, Peter Dodd, Mary Hamilton Kimpton; Richard D. Irwin, Inc. 1985 Second Edition) states that:

> [i]t seems plausible that dividends (and changes in market value) should determine the value of a common stock, and also plausible is the belief that only earnings matter. A choice between these plausible and superficially inconsistent beliefs is unnecessary because, as Miller and Modigliani[65] have shown in a rightfully famous

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[64] MCI Opposition, CC Docket No. 92-101, filed July 1, 1992, Drazen at pp. 2-3.

[65] Merton H. Miller and Franco Modigliani, "Dividend Policy, Growth, and the Valuation of Shares," Journal of Business 34 (October 1961), pp. 411-33. (footnote from original text - other footnotes omitted).

> article, once the underlying assumptions are made explicit and understood, the two hypotheses are equivalent.

Also, the authors state that:

> (f)or common stocks, one cash flow is the dividends received, and it would seem that the value of stock is the present value of future dividends (plus money received on the sale of the stock). Nevertheless, much of the academic literature, the popular press, and the professional financial community discuss the importance of earnings per se rather than dividends as the primary determinate of share value.

Thus, a reduction in stock prices that is matched by a reduction in earnings expectations leaves market measures of risk and cost of capital unaffected. When reductions in stock prices are matched by reductions in earnings expectations, the Commission's represcription of ROR is unaffected.

b. Investors Expected Rate Recovery of Accounting Changes, Including SFAS-106.

The United States Telephone Association (USTA) and the price cap LECs provided substantial evidence that investors expected that SFAS-106 would not affect the cost of capital for the price cap LECs because earnings expectations (and stock prices) were not affected.[66] The existence of postretirement medical liabilities was not new, certainly not to analysts and investors. Incorporation of these liabilities into the stock prices of companies was not affected by or based on the FASB pronouncement, but was economic reality all along. Thus, stock prices were generally not affected by the release of the FASB's Statement. The

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[66] USTA Rebuttal, CC Docket No. 92-101, filed July 31, 1992, at pp. 4-13, especially at pp. 11-12; SWBT Rebuttal, at pp. 36-38.

SFAS-106 mandate affected only the accounting recognition of OPEB costs, the requirement that companies release liability information to the investment community and, potentially, the recovery of those costs for only those companies that are regulated based on accounting costs.

Assuming, arguendo, that stock prices were reduced due to the existence of OPEB liabilities, such effects occurred long before the 1990 FASB Statement was released and not because of the announcement of SFAS-106. If stock prices were reduced by expectations, however, then earnings expectations were reduced concomitantly and the need for exogenous treatment had not been eliminated. Rate recovery for an accounting change such as this cannot be addressed through cost of capital.

Thus, if investors' expectations regarding rate recovery of SFAS-106 had any effect on stock prices and earnings expectations -- and if they had an effect, they must have an effect on both stock prices and earnings expectations because the supposed effect on stock prices results directly from a change in earnings expectations -- then risk and cost of capital would have been unaffected.

The Commission has already addressed this issue in the context of their review of the 1992 annual access tariff filings. Responding to MCI's allegations on this issue, the Commission concluded that ROR carriers' OPEB expenses were proper and did not subject the carrier to an investigation.[67]

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[67] See fn. 59, supra.

No detailed or exhaustive examination on the specific expectations of investors with respect to recovery of SFAS-106 costs is necessary (or practical) in this matter. One need not look to opinions expressed by investors to determine the correct result on this issue. The Commission's own orders and actions gave SWBT and its investors every expectation that the Commission would treat GAAP changes as exogenous, providing an opportunity for rate recovery. The Commission was deliberating the ROR represcription and the LEC price cap plan in parallel proceedings during late 1989 and 1990. The Report and Order and Second Further Notice adopted exogenous treatment for GAAP changes for AT&T and proposed exogenous treatment for GAAP changes for LECs upon a Commission finding that the individual GAAP change was consistent with the Commission's regulatory accounting needs.[68] In 1990, the LEC Price Cap Order explicitly stated that:

> Changes in LEC costs that are caused by changes in Part 32 of our Rules, the Uniform System of Accounts (USOA), will be considered exogenous. ... Carriers must notify us of their intention to apply a change in GAAP and we will allow such a change if we find it to be compatible with our regulatory accounting needs.[69]

The current ROR prescribed for all carriers under ROR regulation and used as the basis for the LEC price cap sharing zones did not incorporate any incremental rate recovery for the

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[68] Report and Order and Second Further Notice at para. 654 and proposed rule Section 61.44.

[69] LEC Price Cap Order at para. 168. Note that the ROR represcription order was adopted on September 19, 1990, together with the LEC Price Cap Order.

increased costs recognized under SFAS-106. The Commission did not alter or increase the rate of return to incorporate the increased OPEB costs that would be recognized under SFAS-106. There was absolutely no mention of OPEBs or SFAS-106-like costs in the record of the ROR represcription proceeding and certainly no mention in any resulting Commission orders in the ROR dockets. (Certainly, a factor as significant as SFAS-106 would have merited special recognition by at least one of the parties had it had such an effect on stock prices and, concomitantly, on the rate of return.) When initial rates were established for the price cap LECs, the Commission represcription of ROR did not result in any increased rate recovery of the increased SFAS-106 costs that price cap LECs would subsequently be forced to recognize under Part 32 of the Commission's Rules.

The Commission's ROR actions preceded the FASB's SFAS-106 actions and could not have reflected the SFAS-106 mandate. The Commission adopted its ROR order on September 19, 1990 and the LEC Price Cap Order was adopted on September 19, 1990 and released on October 4, 1990. The FASB Statement, SFAS-106, was not released until December of 1990. No mention is made in the entire record in CC Docket No. 89-624 of the effects of SFAS-106 or accrual accounting for OPEBs on stock prices, earnings expectations or cost of capital.

The information utilized by the Commission on the record in the ROR represcription docket included historical information as new as 1989 with limited updates of some information from early 1990. As discussed herein, the prevailing regulatory precedent during 1989 and early 1990 was that the Commission would grant exogenous treatment for GAAP changes after they became effective. Thus, investors' expectations were conditioned by the Commission's assurances that GAAP changes would be treated as exogenous.

c. **<u>Anecdotal Evidence Confirms That Investors Expected Rate Recovery of Accrual Accounting For OPEBs</u>.**

Investors' expectations are also indicated by anecdotal evidence from reports written by rating agencies and investment brokers. For instance, Standard & Poor's stated that it expects that, in general, utilities will be allowed by regulators to recover SFAS-106 costs in rates:

> As regulated monopolies, utilities are entitled to recover their cost of service, including a return on equity, through rates. While all costs are subject to regulatory scrutiny, one assumes that prudently incurred costs will, for the most part, be recovered. ... [Standard & Poor's] continues to believe that there is no need for widespread concern over this "new" liability in the case of utilities. Under a worst case scenario, unresponsive regulatory treatment which leads to a reduction in cash flow may result in immediate negative ratings actions.[70]

earnings caused by denial of rate recovery will have a direct effect on both earnings expectations and stock prices. As discussed above, this did not result in any rate recovery in the Commission's ROR represcription.

d. The Commission Cannot Sustain a Finding Regarding Potential Double Counting in the ROR Represcription Based Either on Conjecture That Such an Effect is Possible or a Finding That the Price Cap LECs Have Not Proved That an Effect Does Not Exist.

MCI claims that the LECs have presented no evidence to suggest that investors assumed rate recovery for SFAS-106 costs.[71] MCI's specific allegation is:

> No LECs present any empirical evidence that there is absolutely no impact on cost of equity from marketplace concerns on SFAS-106 liabilities.[72]

The LECs are under no obligation to respond to irrelevant issues in this docket.[73] No party has shown that there is enough of a prima facie connection to obligate a response.

The Commission cannot sustain a finding that double counting exists with respect to the ROR represcription without some reasonable basis on which to do so. The current statements by the Commission offer the price cap LECs no explicit rationale for concluding that a ROR represcription double count effect exists and

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[71] MCI Petition to Reject, at p. 17.

[72] Id.

[73] Just because the instant proceeding is ostensibly grounded in a Section 204(a) proceeding does not require that the carrier hold the burden of persuasion against each allegation that the tariff change is not "just and reasonable." Copley Press, Inc. v. FCC, 444 F.2d 984, 987-989 (D.C. Cir., 1971).

[redacted]

[redacted]

[redacted]

a. <u>The Present Value of SFAS-106 is Greater Than the Present Value of Pay-As-You-Go.</u>

The implicit view in the <u>January Order</u>, that the time value of money is not important in regulatory framework, is wrong. The following simplified SFAS-106 example illustrates that SWBT will not be made whole by the normal operation of the price cap index formula without exogenous treatment.

		SFAS-106 Calculation			
Year	**Pay-as-you-go**	**EPBO**	**APBO**	**Service Cost**	**SFAS-106 Expense**
1	$0	$681	$0	$136	$147
2	0	735	147	147	171
3	0	794	318	159	197
4	0	857	514	171	226
5	$1,000	926	741	185	259
Total	**$1,000**				**$1,000**
Present Value of Yrs. 1-5	**$681**				**$843**

The above table presents a simple SFAS-106 calculation as follows:

> Payments of $1,000 in OPEB claims are made at the end of year 5. This represents pay-as-you-go accounting.
>
> The Expected Postretirement Benefit Obligation (EPBO) is the present value in each year of the expected OPEB claims. The present value calculation here uses an 8% discount rate. Thus, the EPBO in year 1 is the present value of $1,000 discounted by 8% for five years, or $681.
>
> The Accumulated Postretirement Benefit Obligation (APBO) is the amount of the EPBO

that has already been recognized at the beginning of each year.

Service Cost is the amortized portion (one fifth in this example) of the EPBO.

The SFAS-106 Expense amount is the Service Cost plus interest on the APBO less any return on Plan Assets.[77]

The above table illustrates that the total of the nominal cash expense under pay-as-you-go accounting, the first column of dollar amounts, and the total of the nominal cash expenses under SFAS-106 accounting, the last column of dollar amounts, are exactly the same, $1,000, in this simplified example. This, however, does not imply that increased rate recovery is not needed. The present value of the two streams of dollars are clearly not the same. Using the same 8% discount rate used in the other calculations, the present value of the pay-as-you-go amounts is $681, while the present value of the SFAS-106 expenses is $843, significantly higher than under pay-as-you-go accounting. Thus, the presumption that the price cap LECs would be made whole over time is incorrect.

SFAS-106 causes a permanent acceleration of expenses into current periods. In fact, it is exactly this permanent acceleration of expenses that the FASB meant to occur. The existence of the TBO does not alter the existence of this acceleration. Accounting for the TBO, carriers are required to reflect in current periods costs that are associated with benefits

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[77] This example assumes that no internal funding is done. An example with full funding yields similar results. More complex examples yield the same conclusion -- the present value of SFAS-106 expenses is greater than the present value of pay-as-you-go expenses.

earned in prior periods. If the above example were altered to reflect the TBO, the same inequality would be observed.

b. A Reasonable Time Horizon Must Be Considered When Determining Regulatory Treatment of OPEB Accounting.

Even ignoring present value differences, the debate over whether the expense streams under pay-as-you-go are equal to or less than the expense streams under SFAS-106 is a useless academic exercise. Regulation must apply over some reasonable period of time. Over any reasonable regulatory time horizon, expenses under SFAS-106 are significantly higher than under pay-as-you-go accounting. Adoption of accrual accounting causes a permanent acceleration of costs into the current time periods.[78]

The Commission has already recognized the need to move to SFAS-106 accrual accounting for OPEBs. The need to allow price cap

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[78] In fact, the Commission has explicitly determined that there are benefits in matching costs with the relevant time periods:

> So long as the present large reserve deficiency exists, carriers' rates will not accurately reflect the costs incurred in providing service. It is in the public interest to eliminate this mismatching of costs and rates as quickly as possible so that carriers and ratepayers do not make decisions based on inaccurate data and assumptions. Our initiation of action now will eliminate the risks of economically inefficient pricing signals associated with extending a cure of the large deficiency into the future.

<u>Amortization of Depreciation Reserve Imbalances of Local Exchange Carriers</u>, 3 FCC Rcd 984 (1988), at para. 17.

LECs the opportunity to align rates with these costs should also be recognized.

The Commission must determine a reasonable time horizon, for its consideration of "intertemporal double counting," asking whether that time period should be four years, eight years, or longer? Recent events indicate a shorter time period. The AT&T price cap plan became effective July 1, 1989. By June of 1993, four years later, the Commission had removed a significant portion of AT&T interstate services from price cap regulation and was considering further regulatory relief.

With expanded interconnection and rapid new market entry, the local exchange market may be poised today where the interexchange markets were in 1988 or 1989. The Commission must ask itself the following question: Is five years too long a planning horizon for considering the effects of regulatory decisions affecting rate recovery of OPEB costs? Will local exchange and access competition progress as rapidly as did interexchange competition?

Competition is already vigorous in major segments of LECs' markets, e.g., the high capacity portion of the access and local exchange markets. Competition may soon be fierce in the switched transport and local switching portions of the access and local exchange markets. The local loop portion of the business may

Standard & Poor's has concluded that the competitive environment is changing for utilities. It believes that as competition and deregulation come to pass, the establishment of a regulatory asset, which represents "temporarily deferred recovery,"

4. **"Double Counting" in the Productivity Study is not a Valid Concern.**

The January Order expressed a concern regarding an unresolved double counting issue related to the Commission's short-run productivity study in Appendix C of the LEC Price Cap Order.[80] The January Order asks:

> (1) what would have been the effect on the productivity studies of excluding these costs, and; (2) how would the Commission have weighed this change in the results of the studies in setting the productivity factor.

The MO&O concludes that this issue has not been sufficiently addressed.[81]

The Commission's apparent concern about double counting of SFAS 106 in the productivity offset is based on an inappropriate view. The Commission may believe that the productivity offset should have been set using only pay-as-you-go OPEB expenses.

For the Commission to conclude that a double count in the productivity offset exists, it must reach a finding of fact that: (1) The exogenous amounts requested by price cap LECs that prefunded VEBA obligations actually included the VEBA funding amounts already reflected in price cap rates; or (2) VEBA funding amounts should not have been included in the Commission's productivity study because these amounts are not legitimate regulated costs of service. Because neither of these two findings

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[80] January Order, at para. 72.

[81] MO&O, at para. 29.

can be made, no double counting in the productivity offset can be

found to exist.